

October 25, 2010

Via Email: PosLimits@CFTC.gov

David Stawick Secretary Commodity Futures Trading Commission 1155 21st Street, N.W. Washington, D.C. 20581

Re: <u>Pre-Rulemaking Position Limit Comments</u>

Dear Mr. Stawick:

CME Group ¹ respectfully submits the following comments for the Commission's consideration in advance of the Commission's planned rulemaking on position limits on certain contracts in exempt and agricultural commodities. CME Group believes that the core purpose that should govern Federal and exchange-set position limits, to the extent such limits are necessary and appropriate should be to reduce the threat of price manipulation and other disruptions to the integrity of prices. Such activity destroys public confidence in the integrity of our markets and harms the acknowledged public interest in legitimate price discovery. Like the Commission, CME Group is therefore vigilant in seeking to deter and prevent price manipulation or other illegitimate distortions of market prices.

Speculation, however, is not manipulation, nor is it an abusive practice. As CME Group observed in its response to the Commission's January 2010 energy position limits proposal, speculation is essential to the orderly functioning of futures markets—it provides market liquidity which promotes more effective commodity price discovery and allows for the efficient transfer of price risk. See CME Group Comments, 10-002 Comment CL-02714, at 2 (Apr. 26, 2010) ("CME Comments"). The Commission's responsibility and challenge is not to restrict speculation per se, but to act when necessary to prevent "excessive speculation" from burdening interstate commerce through what the Commodity Exchange Act ("CEA") calls "unreasonable" and "unwarranted" fluctuations in the price of a commodity. To this end, Congress has granted to the Commission the authority to impose speculative position limits under Section 4a of the CEA, as amended by the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank").

For the record, CME Group is the holding company for four separate Exchanges, including the Chicago Mercantile Exchange Inc. ("CME"), the Board of Trade of the City of Chicago, Inc. ("CBOT"), the New York Mercantile Exchange, Inc. ("NYMEX"), and the Commodity Exchange, Inc. ("COMEX") (collectively, the "CME Group Exchanges" or "Exchanges"). The CME Group Exchanges offer the widest range of benchmark products available across all major asset classes, including futures and options on futures based on interest rates, equity indexes, foreign exchange, energy, metals, agricultural commodities, and alternative investment products. Moreover, the Exchanges serve the hedging, risk management, and trading needs of our global customer base by facilitating transactions through CME Globex® electronic trading platform, our open outcry trading facilities in New York and Chicago, and privately negotiated transactions. CME Clearing is one of the largest central counterparty clearing services in the world; it provides clearing and settlement services for exchange-traded contracts and over-the-counter ("OTC") derivatives contracts through CME ClearPort®. The CME ClearPort® service mitigates counterparty credit risks, provides transparency to OTC transactions, and brings to bear the exchange's market surveillance monitoring tools.

Our comments regarding the Commission's § 4a position limit authority will focus on: 1) the statutory requirements for the Commission's establishment of position limits, and 2) the features the Commission should adopt for any necessary position limit regime (e.g., timing, exemptions, and aggregation standards). In offering these comments, CME Group has been cognizant of the extensive demands that are being made on the Commission's limited resources. However, the Commission must gather critical data regarding swap markets and individual traders' swap positions. Without a thorough understanding of such data, the Commission runs the risk of inappropriately setting position limits. CME Group appreciates the great challenge this presents to the Commission and suggests in this letter ways to reduce the strain on the Commission's resources while still serving our mutual goal of effective market surveillance to deter price manipulation and other abusive practices.

I. Statutorily Required Basis for Imposing Position Limits

Section 4a(a)(1) provides in pertinent part:

For the purpose of diminishing, eliminating, or preventing such burden [of unwarranted or unreasonable price fluctuations resulting from excessive speculation], the Commission shall . . . fix such limits on the amount of trading which may be done or positions which may be held . . . as the Commission finds are necessary to diminish, eliminate, or prevent such burden. (emphasis added)

By its terms, the statute requires the Commission to make a finding that position limits "are necessary to diminish, eliminate, or prevent" burdensome excessive speculation before imposing such limits. Dan Berkowitz, CFTC General Counsel, confirmed that Section 4a(a)(1) sets forth a *conditional* mandate during the CFTC's July 2009 hearings on energy position limits. In response to Chairman Gensler's question, "What does the word 'shall' mean in 4a?," Berkowitz replied, "If the Commission finds that position limits are necessary to prevent, diminish, or eliminate such burdens, *then* there is a directive that it shall establish position limits." Transcript of July 28, 2009 CFTC Hearing on Energy Position Limits at 35-36 (emphasis added). The above quoted language from Section 4a(a)(1) was not deleted or in any way altered by Dodd-Frank. New CEA subsection (a)(2) ("Establishment of Limitations") even reaffirms that any position limits must be established "[i]n accordance with the standards set forth in paragraph 1 of this subsection," which include the requisite "necessary" finding.

Moreover, the Commission must publish the statutorily required finding and the information in support thereof in any notice of proposed rulemaking to comply with the Administrative Procedure Act ("APA"). The APA requires that the notice of a proposed rule include "sufficient detail on its content and basis in law and evidence to allow for meaningful and informed comment." See, e.g., Am. Med. Ass'n v. Reno, 57 F.3d 1129, 1132 (D.C. Cir. 1995). Absent a finding with supporting evidence that position limits are "necessary," this APA requirement cannot be met because the public will not know the Commission's specific reasoning for the essential finding that triggers its proposed rulemaking.

As the Commission proceeds to determine whether position limits are "necessary," it should be guided by the statute's own terms, which indicate that such limits would be "unnecessary" where burdensome excessive speculation does not exist or is unlikely to occur in the future. CME Group's comment letter on the Commission's energy position limits proposal discussed at length the absence of any credible empirical evidence of the existence of burdensome excessive speculation or its likely future occurrence. See CME Comments at 17-24. The weight of empirically sound analysis and research demonstrates that movements in commodity prices are attributable to fundamental market conditions rather than speculative trading. CFTC studies, for example, have found that supply and demand factors were largely responsible for the 2008 rise in oil prices and that, far from harming the market, speculators serve as an important source of liquidity for other participants. See, e.g., CFTC Interagency Task Force on Commodity Markets, Interim Report on Crude Oil at 3-4 (July 22, 2008); Michael Haigh et al., Market Growth, Trader

Participation and Pricing in Energy Futures Markets (Feb. 7, 2007), available at http://web.uvic.ca/econ/research/seminars/robe.pdf. Like CFTC staff, the Government Accountability Office ("GAO") has not identified a causal relationship between speculation in the futures market and changes in commodity prices. See GAO, GAO-09-285R, Issues Involving the Use of the Futures Markets to Invest in Commodity Indexes at 5 (Jan. 30, 2009). The conclusions of these governmental studies and reports are consistent with those of academic and private sector economists. See, e.g., Paul Krugman, The Oil Nonbubble, N.Y. Times, May 12, 2008, http://www.nytimes.com/2008/05/12/opinion/12krugman.html ("[T]he rise in oil prices isn't the result of runaway speculation; it's the result of . . . the growing difficulty of finding oil and the rapid growth of emerging economies like China.").

To the extent there are any legitimate concerns with the potential for excessive speculation to cause unwarranted or unreasonable price fluctuations, CME Group believes that futures exchanges effectively address such concerns through their existing market surveillance programs. CME Group provided a detailed account of the futures exchanges' capabilities in its April 26, 2010 comments. See CME Comments at 8-12. Briefly stated, the exchanges independently have the ability to establish position limits as warranted by the characteristics of their traded contracts, and to employ position accountability provisions as appropriate given particular market constructs and market conditions. This flexible regulation is a much more appropriate and effective means of addressing potentially manipulative or disruptive positions than are blunt position limits that fail to account for variability in specific contract months, market conditions, and market participation.² Insofar as the existing exchange programs are and have been proven to be effective, CME Group believes the Commission would lack the statutory basis for establishing new Federal position limits on certain contracts involving exempt and agricultural commodities.

CME Group acknowledges, however, that the Commission may have market-wide surveillance concerns that the exchanges are not always able to address. Again, CME Group maintains that accountability rules are a less intrusive, more effective tool for monitoring the trading activities of market participants than are hard limits. As FIA suggested in its comments on the Commission's energy position limits proposal, the Commission should consider imposing aggregate accountability levels where multiple trading platforms exist for a commodity. See FIA Comments, 10-002 Comment CL-02687, at 5 (Mar. 18, 2010) ("FIA Comments"). Position limits would only be "necessary" if the aggregate accountability rules failed to deal with the Commission's market surveillance concerns.

II. Mechanics of Imposing Position Limits

Assuming the Commission is able to find that position limits "are necessary to diminish, eliminate, or prevent" burdensome excessive speculation, CME Group offers the following views on how to impose those limits:

A. <u>The Imposition of Limits Should be Deferred Until the Commission Can Properly Determine and Ensure Compliance with Appropriate Limits</u>

Recent experience with some funds sheds doubt on the efficacy of using the blunt instrument of position limits to combat perceived high commodity prices. In anticipation of possible hard limits that the Commission proposed last January, certain funds that seek "long" exposure to commodities effectively shifted from futures and other derivatives to acquiring and holding the physical commodity itself. This buy and hold strategy is of course unaffected by any position limits the Commission or the exchanges might impose. However, by purchasing and holding physical commodities, the funds do affect the supply and demand equation for that commodity, depending on the size of their physical commodity holdings, and could actually contribute to higher commodity and consumer prices. The Commission may want to consider this unintended consequence of even proposing hard position limits as it formulates its policy on position limits through the rule making process.

Dodd-Frank sets forth several seemingly inconsistent timing requirements for the exercise of the Commission's position limit authority. New CEA § 4a(a)(2)(B) directs the Commission to impose limits for certain contracts, within 180 days for exempt commodities and within 270 days for agricultural commodities, respectively, of Dodd-Frank's enactment. Meanwhile, new CEA § 4a(5)(A) requires that limits for swaps that are economically equivalent to futures and options be established simultaneously with the limits under Section 4a(a)(2)(B). The statute, however, also vests the Commission with discretion to establish limits "as appropriate," thereby indicating that the Commission is not bound by the aforementioned dates. CME Group thus urges the Commission to defer imposing limits until doing so would be "appropriate"—that is, when it has the data needed to accurately set and enforce those limits and when it is in a position to impose limits simultaneously on futures (and options on futures) and swaps.³

B. <u>Position Limits Should Be Set with Due Regard for Legislative Objectives and Considerations</u>

Under Dodd-Frank, the Commission is required to take into account several factors when setting position limits. New CEA \S 4a(a)(3) provides that, to the maximum extent practicable, the Commission should use its discretion to establish limits to: (i) diminish, eliminate, or prevent "excessive speculation"; (ii) deter and prevent market manipulation, squeezes, and corners; (iii) ensure sufficient market liquidity for bona fide hedgers; **and** (iv) ensure that the price discovery function of the underlying market is not disrupted. Additionally, new CEA \S 4a(a)(2)(C) states that the Commission must act to avoid shifting the price discovery function to FBOTs in establishing limits. In mandating these considerations, Congress recognized that limiting trading positions has the potential to reduce liquidity and adversely affect the hedging and price discovery functions of U.S. commodity markets. The Commission is obliged to give due weight to each consideration in setting any position limits and may not focus solely on imposing limits to diminish, eliminate, or prevent "excessive speculation."

C. <u>The Commission's Exemptive Authority Should Be Interpreted Broadly To Accommodate</u> All Non-Speculative Positions

New CEA § 4a(a)(7) gives the Commission authority to exempt from any position limit rule, with or without conditions, "any person or class of persons, any swap or class of swaps, any contract of sale for future delivery or class of such contracts, any option or class of options, or any transaction or class of transactions." Under this provision, the Commission's statutory power to exempt any person or class of person from position limits is greater than it has ever been before.

CME Group encourages the Commission to use its broad new exemption authority under § 4a(a)(7) to grant exemptions to market participants who use futures, options, or swaps when economically appropriate to the reduction of the risks they face in their enterprises. Although it is impossible to enumerate the breadth of exemptions that should be permitted in order to ensure that entities are able to effectively manage exposure that is highly correlated to fluctuations in the price of exempt and agricultural commodities, an application for exemption should be judged on its merits in terms of the specific risks to be hedged, the relevant price relationships, the proposed position sizes, and the operational procedures for establishing and lifting the hedge.

If the Commission were to narrowly construe its \S 4a(a)(7) exemptive authority to exclude non-speculative trading activity, then market participants could be forced to either actually speculate on those price risks (i.e., not establish any positions to mitigate the risk), and potentially increase costs to consumers, or

The Commission would also have to capture data across foreign boards of trade ("FBOTs") as new CEA § 4a(a)(6)(B) requires that any CFTC-set aggregate position limits include contracts that price settle against contracts listed on certain FBOTs.

hedge their risks through transactions that lie outside the CFTC's position limit authority. Either strategy would undermine the Commission's mission to promote liquidity and protect the price discovery function of its regulated markets. The Commission should thus broadly interpret its exemptive powers and grant exemptions to market participants who are not seeking to establish positions in the futures market for speculative purposes but rather to serve their legitimate commercial and financial hedging needs.

D. "Crowding Out" Rules Should Not Be Used as They Are Unauthorized and Unnecessary

Rules designed to "crowd out" hedgers should not be proposed for the Commission's exercise of its new position limit authority. The following example, provided in FIA's March 18, 2010 comments, illustrates how a "crowding out" provision works: Assume that a speculative position limit is 1000 contracts and a bona fide hedger holds 1200 hedging positions (pursuant to an exemption that allows him to hold up to 2000 hedging positions). If the bona fide hedger acquires even one speculative position, he violates the speculative position limit because his *combined* hedging and speculative positions (1201) exceed that position limit. See FIA Comments at 22-23. Such a result contravenes Section 4a(c) which prohibits applying a speculative position limit to bona fide hedging positions. Moreover, the "crowding out" rule exceeds the CFTC's legal authority under Section 4a(a) by prohibiting speculation that is well within the position limit and hence, by definition, is not "excessive." The Commission should not prohibit a hedger from holding otherwise permissible speculative positions.

E. Position Aggregation Requirements Should Be Based on Common Control

CME Group agrees with FIA's recommendation that the Commission apply the aggregation requirement for exchange-imposed position limits to any new Federal position limits. See FIA Pre-Rulemaking Position Limit Comments and Recommendations at 9-10 (Oct. 1, 2010). Commission Regulation 150.5(g) requires exchanges to aggregate positions in two manners for purposes of determining compliance with position limits. First, exchanges must aggregate "all positions in accounts for which [a] person by power of attorney or otherwise directly or indirectly controls trading . . . with the positions held by such person." 17 C.F.R. § 150.5(g). Second, exchanges must aggregate "positions held by two or more person[s] acting pursuant to an express or implied agreement or understanding, the same as if the positions were held by a single person." *Id.*

Specifically, Regulation 150.5(g) requires a person to aggregate the positions that such person holds (i.e. owns) and controls trading for with the positions owned by others that the person controls trading for because such positions are subject to the person's common control. The CME exchanges also aggregate the positions of different entities with common ownership (10% or greater financial or equity interest) on the assumption that such ownership may indicate common control—a view that the Commission endorsed in its 1979 Statement of Policy on Aggregation. See 44 Fed. Reg. 33839, 3384 (June 13, 1979) (stating that "quite apart from considerations of ownership, any financial interest may also be indicative of control of the account"). For the presumption of common control to be rebutted and disaggregation to be permitted, the CME Group exchanges require an affirmative showing that the commonly owned entities have appropriate firewalls in place validating separate control.

The policy of disaggregating positions in commonly owned, but separately controlled accounts is sensible and sound. Entities that are shown to be merely under common ownership cannot be viewed as trading in concert or trying to affect prices in the same way if they are subject to independent management, often with separate information systems and procedures for back office operations. In other words, such entities should not have their positions aggregated because they cannot be said to have an aggregate effect on the market.

In contrast, any proposal to require aggregation where commonly owned entities can demonstrate separate control would be unwise, inappropriate, and unworkable. Such entities would need to share position and trading information to monitor and allocate limited position volumes, notwithstanding the

independence of trading control. This sharing of information, in turn, would have the perverse effect of raising the potential for trading in concert. The disclosure of information may also breach the confidentiality of a particular entity's trading strategies or compromise an entity's fiduciary duties to its clients. Furthermore, entities would have to implement massive, costly infrastructure changes—e.g., dismantling information barriers and restructuring information systems and procedures—to share information and manage their positions on a "real-time" basis even though, again, these entities are not related to one another in any meaningful way. Faced with the many compliance costs flowing from the lack of an aggregation exemption for separate control, market participants might move their trading activity to unregulated, less transparent markets, thereby reducing the liquidity and disrupting the price discovery of U.S. commodity markets—precisely the opposite result of what the Commission seeks to achieve.

III. Conclusion

CME Group appreciates the opportunity to offer the foregoing comments in advance of the issuance of any proposed rules imposing position limits on certain contracts involving exempt and agricultural commodities. We hope that the views expressed herein prove to be helpful to the Commission and we are available to answer any questions the Commission may have.

Sincerely,

Craig S. Donohue

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